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# Competitive Sourcing and Privatization: An Essential USAF Strategy

Lieutenant Colonel Stephen E. Newbold, USAF

Why is Outsourcing and Privatization necessary?

The hardest things to change are institutions that have been successful and need to change anyway.

—John White, Deputy Secretary of Defense

## Introduction

No longer is the US faced with national survival as was the case in 40-plus years of nuclear standoff with the Soviet Union. However, in many ways, the world is far more complex than during the years of the Cold War. The Cold War bipolar alliances have given way to a world where regional interests dominate. Today, terrorism and the threat of nuclear, biological and chemical weapons proliferation—along with renewed national, ethnic and religious rivalries—dominate the international scene.

As America seeks to reap the benefits of *winning the Cold War*, the nation is faced with tough decisions regarding how much defense is needed in the *new* world. Service force structures have been rapidly reduced and weapon system inventories drastically slashed. At the same time, personnel have exited the ranks of the military in increasing numbers.

[The] DoD's [Department of Defense] force structure today is roughly 30 percent smaller than it was in the 1980s. Our budget has also declined to about 60 percent (in real terms) of its peak in 1985.<sup>1</sup>

These cuts, felt by all the Services, created imbalances that must be corrected. Among these imbalances is the disproportionate growth in the *tooth-to-tail* ratio since the end of the Cold War. The tooth-to-tail issue is considered such a major concern that Defense Secretary William Cohen established a commission chartered with the responsibility of finding ways to correct the problem. In this regard, the commission was charged with finding

... ways to save money in the defense *tail* portion of the budget ... while shifting those savings to the *tooth*—warfighting segment. That ratio, nearly a 50-50 balance at the end of the Cold War, has moved so that nearly 70 percent of the defense budget now goes toward support elements.<sup>2</sup>

Future declining or flat-line budgets, coupled with the need to reduce the support/warfighter ratio, make changes in the support force structure and support concepts an absolute necessity.

Change, although inevitable because of budget considerations, will not be easy considering the many years of experience with largely organic support capabilities and the successes enjoyed with this approach. From the huge

depot repair capabilities to base level, organic support has been the primary means for meeting Air Force mission requirements. However, it has not always been this way. In fact, today's support

... activities were largely established and organized during the Cold War when [the] DoD had to depend predominately on organic support. Such support was driven by the possibility of an extended conflict with a rival superpower and a less sophisticated private, commercial infrastructure.<sup>3</sup>

To complicate budget and force structure imperatives, future wars are expected to be regional in nature with the US military expected to fight two simultaneous major regional conflicts. "These conflicts are often described as *come as you are* wars, meaning that there will be little lead time for mobilization or surge of production capability."<sup>4</sup> Additionally, today's US military plans for a more mobile and lethal battlefield. Technologically advanced weapons combined with rapid mobility will bring to bear overwhelming firepower on the enemy, creating a dramatic shock effect and producing short-duration conflict.

Today's realities—a changing international scene, budgetary difficulties, force structure imbalances and new operational concepts—demand innovative solutions that will ensure support to the warfighter is not diminished.

Competitive Sourcing and Privatization (CS&P) (formerly Outsourcing and Privatization) is essential to meeting future support requirements. Interestingly, outsourcing and privatization are really not new concepts at all. Prior to World War II, the US military routinely relied upon the private sector for much of its support. Former Secretary of the Air Force Sheila Widnall commented,

Lest you think this is a new phenomenon, let me take you back to the era before World War II when private support was standard. It was only during the Cold War when we realized the huge buildup of government operations that we came to think of government support as the norm. In a sense, we're going "back to the future."<sup>5</sup>

The Air Force must pursue CS&P, using the savings for modernization and procurement to meet future needs. However, care must be exercised in making CS&P a reality, or it may undermine warfighting capabilities. A well thought-out and deliberate implementation strategy is crucial to success.

Converting from an in-house to a contractor-provided workforce is a lengthy and complex process. Rules and regulations abound, making the process difficult to understand. To take full advantage of the benefits of outsourcing and privatization, there must be relief from many of the restrictions currently in place. Further, there must be acceptance and support at all levels of the Air Force for the initiatives involved under CS&P. Transitioning to a predominantly contractor-provided support force may seem a

bitter pill to swallow to many, especially since the in-place organic workforce has traditionally provided quality and responsive support to the needs of the warfighter. However, the existing fiscal demands and budgetary imperatives offer few alternatives. To understand the need, it is first important to understand the terminology, in order to establish a level of common understanding.

### Key Terms Defined

Only those functions considered commercial activities are eligible to be performed under contract. By definition, "A commercial activity is the process resulting in a product or service that is or could be obtained from a private source."<sup>6</sup> However, just because a particular function fits the commercial activities definition does not automatically make it a *contracting candidate*. There are several valid reasons to exempt an otherwise commercial activity from being performed by contract and, conversely, valid conditions to convert a government function to one that is contractor operated. Under CS&P, the government is allowed to perform an otherwise commercial activity when the function is considered a core capability. A core capability is defined as:

A commercial activity operated by a cadre of highly skilled employees, in a specialized technical or scientific development area, to ensure that a minimum capability is maintained. The core capability does not include the skills, functions or FTE [Full Time Equivalents] that may be retained in-house for reasons of national defense, including military mobilization, security, rotational necessity or to patient care or research and development activities.<sup>7</sup>

There are also some areas that are considered organic functions of the federal government that are exempt from CS&P initiatives. The term *inherently governmental activity* is applied to those areas in which performance by a commercial contractor does not serve the interests of the nation because of the nature of the work itself. It is "an activity that is so intimately related to the public interest as to mandate performance by federal employees."<sup>8</sup> Typically, functions fall in this category because of the government's responsibility to the taxpayers. A contracting function or a government audit function is a typical example of an area that is considered inherently governmental.

### Competitive Sourcing and Privatization Savings

The DoD's experience with outsourcing seems to confirm that savings are substantial when comparing organic to contract support.

Cost comparisons conducted between 1978 and 1994 show savings of about \$1.5B a year. The military departments and defense agencies that took advantage of outsourcing via competition have reduced their annual operating costs by about 31 percent.<sup>9</sup>

Similarly, within the Air Force, outsourcing has saved an estimated \$500M a year according to Colonel Michael A. Collins, former Chief of the Air Force Outsourcing Office.<sup>10</sup> Further, the Defense Science Board Task Force on Outsourcing and Privatization estimated "savings of up to \$7B to \$12B annually by Fiscal Year 2002 . . ."<sup>11</sup> It is important to note, however, that both actual and projected

savings are somewhat suspect according to the General Accounting Office (GAO). In testimony to Congress, the GAO noted that it has been unable to substantiate the savings claimed by the DoD for a variety of reasons. Among the reasons are generally poor cost-capturing procedures within the DoD and a noticeable trend in cost growth in established contracts.<sup>12</sup> Unlike private industry, the DoD is not a profit-making enterprise. As a result, managing costs has historically not been a strong suit for the defense establishment. As it tries to capture costs associated with a particular activity, the DoD's limited cost-managing experience makes the effort difficult and the results somewhat suspect. Similarly, the DoD's experience in writing service contracts has frequently resulted in contract modifications to the original contract, which routinely adds workload to the contract and increases costs. The cost savings claimed by the DoD under CS&P come exclusively from comparisons with initial contracts and not those that have been modified.<sup>13</sup> Recently, the GAO was tasked to review existing contracts to determine the actual cost growth.<sup>14</sup> In spite of the GAO claims of inconclusive cost savings, the available evidence as highlighted by the Defense Science Board and others makes a strong case for outsourcing and privatization.

One of the areas severely impacted during the defense drawdown has been procurement. Funding for procurement has fallen well below the levels needed to replace older weapon systems and ensure a technological advantage.

Over the next five years, the military will have to nearly double its spending on weapons, pouring \$67B a year into new planes, ships and other weapons to replace those that are wearing out and to maintain technological superiority on the battlefield.<sup>15</sup>

"In terms of 1996 dollars, procurement has fallen from a peak of \$126B in 1985, to just \$39B in 1996—a reduction of 69 percent."<sup>16</sup> The savings to be generated by competitive sourcing and privatization offers one avenue to reduce procurement funding shortfalls.

### The Process

The Office of Management and Budget Circular A-76, Performance of Commercial Activities, is the cornerstone document for CS&P guidance and is fundamental to cost comparisons between the government and the private sector. The A-76, appropriate federal and DoD acquisition regulations and public laws provide the basis for undertaking the outsourcing decision. The first step in the process is to identify the potential candidates for outsourcing. Next, a Performance Work Statement (PWS) is prepared. The PWS provides the foundation for the entire process.

The PWS defines what is being requested, the performance standards and measures, and timeframes required. It provides the technical performance standards and measures and timeframes required. It provides the technical performance section of the Request for Proposals (RFP).<sup>17</sup>

Simply put, the PWS defines what work is to be done, the timelines for its completion and the standards expected. The PWS should provide flexibility to the performing activity on how to meet job requirements. This flexibility and a properly written contract will normally result in the contractor's identifying and employing improved efficiencies.

The Quality Assurance Surveillance Plan is the government's

oversight plan for the contract and is used to determine contractor performance. This plan "describes the methods of inspection to be used, the reports required and the resources to be employed with estimated work-hours."<sup>18</sup> The QASP provides the *report card* on how well the contractor performs and provides the basis for payment incentives associated with the contract.

Since the essence of the A-76 process is to determine the most effective method—government or contractor—to perform the identified activity, the government must also prepare a bid for the work. The result of this process is the Management Plan.

The Management Plan describes the government's Most Efficient Organization (MEO) and is the basis of the government's in-house cost estimate. The Management Plan, which must reflect the scope of the Performance Work Statement, should identify the organizational structures, staffing and operating procedures, equipment, transition and inspection plans necessary to ensure that the in-house activity is performed in an efficient and cost effective manner.<sup>19</sup>

The Management Plan provides the government with a cost basis for performance of the work and is essential to the competition process.

The solicitation process offers the opportunity for the private sector to bid for the work in competition with the government, with the PWS providing the basis for the work to be performed. The Federal Acquisition Regulation (FAR) provides explicit guidance on the solicitation process. For example, FAR, Part 7 requires confidentiality of the government cost estimate until the most advantageous contractor proposal has been determined.<sup>20</sup> Solicitations must provide open and fair competition, resulting in the best overall value for the government. Once the solicitations have been received, the appointed source selection authority makes the final determination regarding whether to accept the in-house government bid or a bid from the private sector. There is also an appeals process to satisfy any complaints from prospective or unsuccessful bidders.

### The Private Sector Experience

Taken together, outsourcing and privatization are viewed as a primary way of doing business in the private sector and are important ingredients for long-term corporate success. The competitive forces in the US economy drive businesses to look for the most cost-efficient and cost-effective means of delivering their products. As a result, the scope of outsourcing within the private sector has grown widely in recent years. For example, one estimate projected private industry spending of \$100B on outsourcing in 1996 with savings estimated between 10 to 15 percent.<sup>21</sup> There are a variety of ways in which cost savings are generated in the private sector. According to Defense Science Board findings, the savings can generally be described as coming from five main areas: (1) a lower cost and more flexible work force, (2) more efficient business practices enabling staff reductions, (3) more efficient utilization of facilities and equipment, (4) cost avoidance in infrastructure and (5) smaller inventories.<sup>22</sup> In addition to the monetary savings and cost avoidance, there are additional reasons that motivate business to outsource.

Outsourcing allows corporations to focus on their *core activities*. This allows them to direct their energies toward those

areas they consider fundamental in order to capitalize on competitive advantages. Functions necessary for conducting business, but not necessarily considered a core activity, are prime candidates for outsourcing. However, what is not considered a core function for one organization is, or at least should be, the core competency of the company seeking to obtain the contract work. It is important to note that no business, no matter how large or diverse, is able to organically provide all necessary resources to render final product delivery.<sup>23</sup> Specialization is a key to success. By specializing, a company can focus on fewer areas and, therefore, is able to identify and capitalize on opportunities.

"Specialization, whether of labor or capital, facilitates optimal use of inherent or acquired traits, saves time by focusing on a limited number of tasks, encourages job mastery and spurs on innovation."<sup>24</sup> Large, diversified organizations simply cannot respond to the market demand as well as less diversified ones.<sup>25</sup>

Another outsourcing benefit seen is *improved service* to the customer. This is evident in the overall quality of the service provided, the responsiveness to the need and the agility of the service provided.<sup>26</sup>

Outsourcing also enables companies to *gain access to technologies* that might not otherwise be available.<sup>27</sup> This benefit is closely related to the core activity advantage. Generally, large, complex organizations are far less capable of taking immediate advantage of technological advances, especially in non-core areas. For example, a company that relies heavily on computer support but is not in the computer hardware or software business itself may find it beneficial to outsource its computer-support needs.

Outsourcing can also be used to generate *operating capital* for the organization. By divesting itself of a particular non-core function, a company can liquidate assets.<sup>28</sup> Obviously, if there is no need to provide the support organically, there is no need to retain assets required to do the work. The funds from the sale of these assets become available for other purposes or to support core functions. Depending upon the function in question, this can amount to a large sum of money. The amount of capital generated generally corresponds to the function that is outsourced.

### Establishing and Managing the Contract

Establishing a contract within the private sector is fairly straightforward. As a result, the private sector takes significantly less time, on average, to establish a contract than it takes within the government. In fact, "outsourcing timelines in the private sector average about 15 months—less than half the DoD average."<sup>29</sup> The reasons for this situation relate primarily to the extensive bureaucratic process within the federal government. The private sector has fewer contracting restrictions than the government. It not only takes less time but also takes a significantly different view of contracting in general. Market forces and profit dominate the private sector view of contracting, and together they produce a different motivation. Within the private sector:

- Businesses increasingly raise their standards for

qualified suppliers. This serves to restrict the pool of suppliers to the best available. Firms then deepen and broaden this relationship with these suppliers.

- Some companies experience fraud and abuse in their outsourcing activities. However, the private sector is learning to overlook such problems when elimination is not cost effective.
- Increasingly, private sector enterprises emphasize performance over cost, giving increased attention to subtleties of performance that may be difficult to justify objectively. Ultimately, this approach is far more cost effective, even if the products or services purchased are more costly.<sup>30</sup>

Private sector experience with outsourcing within the aircraft support industry offers a particularly good benchmark for the Air Force since many functions are similar. Outsourcing in this industry is now commonplace. In fact, 15 to 20 percent of all the required maintenance is now outsourced with the figure expected to grow.<sup>31</sup> Interestingly, there is a notably different approach to outsourcing when comparing the older, more established companies with the younger ones within the industry.

Major airlines can be divided into two groups: younger airlines that have emerged after the late 1970s (the era of airline deregulation), which outsource virtually all of their depot-level maintenance, and the older, established airlines that maintain most of this workload in-house. All major carriers maintain an internal line ('O-level') maintenance capability.<sup>32</sup>

The reason for the differing approaches is straightforward and primarily dependent on the infrastructure capabilities of older airlines developed over the years. Also, labor unions and corporate

culture are important in the outsourcing decision. The established

... airlines have created an extensive maintenance infrastructure and have strong economic incentives to fully utilize these facilities. Union agreements often prohibit outsourcing of work that can be performed by company employees. In many airlines, the corporate culture also plays a role in discouraging full-scale outsourcing.<sup>33</sup>

Within the airline industry, companies typically look for a long-term relationship with a contractor. This not only provides stability but also produces a partnership-type approach to the business relationship. Five- to ten-year fixed-price contracts are the norm with the rates negotiated annually.<sup>34</sup> In the case of poor performance, contracts can be quickly terminated. Also, airlines have found a means to more directly tie compensation to performance based on the reliability of contractor provided components. Although this approach, known as *power-by-the-hour*, does not necessarily fit all aspects of airline aircraft maintenance, it does offer substantial advantages in some areas, and its use is becoming more common.

Power-by-the-hour (PBTH) arrangements are growing in popularity. Under this approach, the airline contracts for performance, rather than a specific repair, and the vendor assumes material management responsibility for the item. PBTH provides airlines with greater maintenance cost stability and predictability, reduces inventories, and gives vendors strong incentives to improve reliability. PBTH arrangements are most prominent in engines, auxiliary power units, landing gear and tires.<sup>35</sup>

### Challenges for the Air Force

As the Air Force embraces CS&P on a much broader scale, it must overcome many challenges. First, the process needs streamlining. It simply takes far too long to outsource or privatize

Citation	Summary	Citation	Summary
Title 10 US Code Section 2461	Mandates extensive reporting to Congress, including cost-comparison study prior to outsourcing.	Title 10 US Code Section 2469	Depot maintenance work >\$3M may not be outsourced without public/private cost comparison.
Title 10 US Code Section 2464	Logistics requirements defined as <i>core</i> cannot be outsourced.	Sec 8020 Fiscal Year 96 Appropriations Act	Requires MEO analysis of all functions of >10 DoD civilian employees before outsourcing.
Title 10 US Code Section 2465	Prohibits outsourcing of civilian firefighting or security guard functions at military bases.	Sec 8043 Fiscal Year 96 Appropriation Act	No funds for A-76 studies which exceed 24 months for 1 function or 48 months for >1 function.
Title 10 US Code Section 2466	Limits outsourcing of depot maintenance to 40 percent of total.	Sec 317 Fiscal Year 87 Authorizations Act	Prohibits contracting any function at McAlester or Crane Army Ammunition Plants.

Table 1. Governing Directives<sup>37</sup>

an activity. Furthermore, the more complex the function, the longer it generally takes to perform the assessment. The process requires single-function awards to be completed within 24 months and multifunction awards within 48 months. Studies exceeding these established time lines require justification as to why the delays occurred and must be submitted to the Office of Management and Budget.<sup>36</sup> Extensive legal considerations also significantly contribute to making the outsourcing process unwieldy. A macro review of the statutory provisions indicates they undermine the Services' abilities to outsource or at least place formidable roadblocks, thus making outsourcing difficult to accomplish. Table 1 highlights the restrictions and provides a summary of the key issues involved.

It certainly can be argued that most, if not all, of the legal provisions were put in place to safeguard the expenditure of public funds. However, in light of the current emphasis to implement improved business practices within government and to streamline government operations, change must be made. Collectively, the statutory provisions restrict the flexibility of the Services in making outsourcing decisions.

The statutes . . . increase the involvement of Congress in outsourcing decisions and expand opportunities for Congressional micromanagement; require extensive Congressional notifications and reporting, including the preparation of exhaustive cost analysis studies; impose arbitrary limits on the share of depot-level maintenance workload that may be outsourced to private contractors; and establish arbitrary exemptions from outsourcing of selected functions such as fire safety and physical security. Moreover, the history of Congressional reaction to past DoD outsourcing initiatives has a *chilling effect* on DoD activities that are considering contracting out other workload. Taken together, the current legal environment encourages the politicization of the outsourcing decision process, and thereby complicates, delays and discourages DoD efforts to increase its reliance on private vendors for support services.<sup>38</sup>

Although statutory relief is certainly needed in many areas, there are several DoD in-house issues that must also be addressed. Support for CS&P initiatives within the Air Force may be difficult to obtain. Outsourcing and privatization, at both the conceptual level and implementation level, conflicts with the well-established Air Force cultural grain and represents a marked departure from the traditional way of doing business. Considering that defense employees are generally conservative and not prone to taking risks, contracting the workload will be difficult to accept.<sup>39</sup> Resistance to change, especially the magnitude expected with CS&P, is not unusual, no matter what the institution.

Large, successful organizations typically institutionalize and thereby preserve the successful values and procedures that define the status quo. DoD is no exception. Where organic supply exists, DoD organizations will resist any large change, no matter how desirable.<sup>40</sup>

Even more important is the concern that contractors will not provide needed support during contingencies or wartime operations.<sup>41</sup> No doubt readiness and wartime support are valid concerns; however, the Air Force does not plan to outsource areas that affect essential military skills or those functions that are inherently governmental. Essential military skills are those that:

- Directly contribute to combat or combat support.
- Must be filled by military members by law, such as firefighters and security guards.
- Are military by custom or tradition, such as bands or honor guards.
- Are needed to support overseas rotations.<sup>42</sup>

This is a reasonable approach; however, the restrictions prohibiting the outsourcing of firefighters and security guards need to be eliminated. In addition, there needs to be a clear delineation concerning what areas contribute directly to combat or combat support. On the surface, this may seem straightforward, but in reality, it is difficult to define. For example, the fighter pilot flying combat sorties directly contributes to combat. But what about the in-theater aircraft maintainers, transporters and supply personnel? It is precisely this area regarding support personnel where the definition becomes decidedly fuzzy. A reasonable approach is to retain organic support for all those areas required for mobility.

During contingencies and even during the open hostilities of war, contractor support has traditionally been essential for many key aspects of the US military. For example, contractors were employed extensively in the theater of operations during DESERT SHIELD/DESERT STORM and today provide key base support functions for several ongoing operations. While contract support during times of contingency has been common, the criteria for those areas where contract support is both feasible and practical must be further defined. Once this is done, the military needs to work with the contractors during peacetime to ensure uninterrupted support during actual contingencies.<sup>43</sup>

In spite of initiatives to change how the DoD deals with contractors, significant change is still required. Too often there is a general lack of trust on the part of the government as to how the contractor will perform the contract. In this regard, the "DoD often fosters adversarial relationships with contractors rather than the needed partnership."<sup>44</sup> One reason is the intrusive oversight the government maintains over contractors. This oversight is the result of a few bad experiences. The government's answer to fraud has typically been more bureaucratic oversight of the process, penalizing all when only a very small minority of contractors are involved.<sup>45</sup> This is not to say that fraud should be overlooked. As advocated by RAND,

When individual incidents (fraud) occur, the response should not be to revisit the procurement regulations but to punish the perpetrator heavily enough to provide a deterrent for others in the future. That is, enforcement should focus on the isolated wrongdoers when they are caught and not on the activity of contracting as a whole.<sup>46</sup>

In addition, the Air Force needs to rethink how it structures the contracts. Performance-based contracts offer advantages to both the government and the contractor. By focusing on results rather than how the work is accomplished, the contractor is better able to find efficiencies, which result in cost savings for the government, while still providing the level of service desired. While there certainly must be restrictions governing how some critical tasks are performed, even in these areas, there are opportunities to improve efficiency.

The Air Force also needs to be more creative in how it provides incentives to the contractor. For example, the Air Force could make good use of the PBTH methodology mentioned earlier. This approach is particularly suited for current and potential aircraft maintenance contracts. PBTH does an excellent job in directly tying performance to compensation.

## Conclusion

CS&P offers the Air Force potentially large savings that can be directed to critical procurement shortfalls. Clearly, there will have to be a culture change within the Air Force in order to overcome tremendous resistance to change. Just as clearly, CS&P initiatives must not compromise our warfighting capability. In this regard, identifying core functions that should not be outsourced or privatized is critically important and is an area that the Air Force has yet to fully address. Congressional support is needed for relief from arbitrary outsourcing restrictions as well as the excessive reporting and oversight requirements presently imposed. Finally, the Air Force must exercise care in how it pursues outsourcing and privatization. The Defense Science Board's recommendation is to contract as much as possible as quickly as possible, but this could lead to overall disaster. In commenting on this point RAND said,

... the Commission implicitly promotes a rapid program of outsourcing that could lead to early failures. That is, if DoD pursues extensive expanded outsourcing without giving such factors adequate attention, it could fail to realize its expectations about performance and reduced costs. Such failures could discredit the notion of expanded outsourcing before such outsourcing has a chance to prove itself.<sup>47</sup>

A more measured approach based on a well-conceived strategy will better serve the long-term needs of the Air Force.

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## New Logistics Assignments Branch Telephone Numbers

Community	Old DSN	New DSN	Old Commercial	New Commercial
Maintenance	487-3556	665-3556	(210) 652-3556	(210) 565-3556
Log Plans	487-5788	665-2485	(210) 652-5788	(210) 565-2485
Supply	487-6417	665-2684	(210) 652-6417	(210) 565-2684
Transportation	487-4024	665-4024	(210) 652-4024	(210) 565-4024